The Political Economy of Energy Subsidies in Egypt and Tunisia: The Untold Story

For decades, the subsidisation of energy has been a pervasive feature of economies across the Middle East and North Africa (MENA). By supplying electricity, gas, and petrol to households and companies at prices well below the world market average, MENA energy importers and exporters alike have made energy subsidies a hallmark of their industrial policy and a key pillar of their social contract. Though the goals of this policy – facilitating industrialisation and attenuating social inequalities – may be commendable, energy subsidies have come at a huge price for MENA economies. The estimated cost of energy subsidies amounts to about 8.5 percent of regional GDP or 22 percent of government revenues (IMF estimates for 2011). As a whole, the region accounts for half of global energy subsidies. The fiscal burden of this policy has been particular heavy for relatively resource-scarce and labour-abundant countries in the region, such as Tunisia and Egypt, which by the early 2010s have both become net energy importers and have thus seen their budget put under strain, in particular during periods of high oil prices.

Evidence pointing out the manifold distortions of energy subsidies in MENA have not been in short supply. Alongside financial concerns, existing studies have particularly highlighted deleterious effects on the environment, the undue reliance on energy-intensive industries, and the generally regressive distributional consequences of energy subsidies. The latter point is particularly damning as in most countries energy subsidies are an important, if not the only, pillar of otherwise underdeveloped social safety nets and often dwarf other welfare expenditures, such as health and education.

Given the manifest shortcomings of subsidised energy and the persistent advice on the part of international financial institutions (IFIs) to reform, the absence of a meaningful overhaul of the status quo is indeed striking. While some of the difficulties to reform might lie with limited institutional capacity and problems of implementation, most explanations have underlined the importance of the political economy of energy subsidies to explain the persistence of the status quo. By far the most widespread argument in this context is the alleged fear of governments' of a popular backlash and attendant unrest in response to subsidy reductions.

While especially in the light of the Arab Spring this argument seems pertinent, it is incomplete and overlooks obstacles to reform stemming from unintended, yet powerful and politically connected beneficiaries of energy subsidies. After a brief outline of recent reforms of energy subsidies and a summary of the 'standard' political economy explanation, I will highlight the importance of these actors – politically connected businessmen (PCBs) and the army – in the case of Tunisia and Egypt. By demonstrating the extent to which these actors are present in subsidised sectors and often specifically enter because of energy subsidies, I argue that these actors have become key stakeholders in the status quo and have used their leverage to water down reform attempts. Thus, any meaningful reform will have to come to terms with this group of actors.

Energy subsidies in Tunisia and Egypt

Tunisia has established a system of extensive energy subsidies in the form of cheap electricity, gas, and petrol. Since the state has acted as a quasi-monopolist in the production and provision of energy, energy subsidies take the form of a monopolist price setting by the state, with prices generously below the level of the world market. Tunisia was a net energy exporter from the early 1970s until the late 1990s and was able to provide cheap energy from its own domestic resources in this period. With

falling production levels and increasing consumption, the country has turned into a net importer of energy in the late 1990s, having to import nearly 30 percent of its energy needs by 2015. As energy is supplied at below world market prices, the resulting deficit of Tunisia's two main energy providers (STIR for oil; STEG for gas and electricity) is covered by transfers from the state budget. With the rapid rise of oil prices during the most recent oil boom, the costs of subsidised energy have hovered between 4 and 6% of GDP or about 13% of the total expenditures over the past 10 years, and only abated recently as a result of falling world market prices.

To alleviate this fiscal burden, the authorities introduced an automatic indexing mechanism of local petrol prices on the world market price in 2009, which was repealed shortly after the uprisings in 2011. In the wake of the ouster of President Ben Ali and under the aegis of an IMF-led stabilisation programme, the Tunisian government increased the price of fuel by 7% in 2012 and 2013, and also hiked up electricity and gas prices for medium-voltage consumers by 20% in 2014. The authorities also reintroduced the automatic indexing mechanism for petrol and began the gradual fading out of energy subsidies for a few energy-intensive industries, such cement, textiles, ceramics, and food processing. On the whole, though, there has been no serious attempt at a systemic overhaul of energy subsidies post-2011.

Like Tunisia, Egypt has also maintained an extensive system of energy subsidies, which offers energy products, such as petrol, gas, and electricity, at favourable rates below the world market price. While energy subsidies have never been 'cheap' in Egypt, the costs soared after the 2011 uprising as Egypt transitioned for a net exporter to a net importer of energy and oil prices peaked as a result of political turmoil in MENA . In 2013 and 2015, energy subsidies thus amounted to nearly 16 and 10% of GDP respectively.

In view of Egypt's strained post-2011 budget, successive governments have carried out a number of price increases, such as in July 2014 when prices rose by as much as 78% for most consumers, including low-income households. In the same vein, the Sisi administration reduced subsidies for a number of energy-intensive industries, such as cement, fertiliser, and glass and ceramics. Another wave of electricity and fuel price increases occurred in late 2016 in the run up to the conclusion of Egypt's recent IMF programme when the government increased fuel prices and electricity prices for households between 30 and 50%; increases for commercial consumption were considerably lower. While the stated goal of the government is to phase out all energy subsidies within a 5-year period, the main policy measures to date have consisted of ad hoc price increases which have overall maintained comparatively low domestic prices. For example, the most expensive price for fuel and electricity still only represent 32 and 0.6% of average US prices respectively.

The Told Political Economy Story: Mobilised Beneficiaries

In both countries, the reluctance to reform energy subsidies is attributed to past popular revolts against price hikes of subsidised goods. Food riots in response to food subsidy cuts are believed to have left a particularly enduring legacy. In Tunisia, these events hark back to a series of riots that lasted from December 1983 until January 1984. Representing the worst violence since independence, protests left about 100 people dead and caused considerable devastation as a result of rioting and plundering. In view of the public discontent, Bourguiba first announced to reduce the price increase by 50%, before scrapping the measure entirely a few days later.

In Egypt, the major event dates back to 18 January 1977 when President Sadat announced price increases for a number of subsidised food items, such as rice, tea, and gas cylinders for households.

Demonstrations against the measures first broke out in Egypt's centre of steel production, Helwan, and quickly spread to the urban centres of Cairo, Alexandria, and other big cities, mobilising industrial workers, students, state employees, and, to a lesser extent, the urban poor along the way. As demonstrations rapidly turned violent, with administration buildings and consumer centres being attacked and burnt, a state of emergency was declared in several provinces and the regime deployed the army for the first time since 1952 to quell the unrest. Rioting only stopped after Sadat repealed the measures on 20 January. The army had to be called upon a second time when minor increases in the price of bread prompted rioting in the textile centre of Kafr al-Dawwar in 1984.

Evidence for the long-lasting effect of these events can be found in statements of policy-makers and archival sources alike. For example, Monceur Rouissi, former minister and personal advisor to President Ben Ali, described the subsidy issue as a 'nightmare for all successive governments, too sensitive to be reformed' (personal interview, Tunis 2013). And according to former and current Minister of Supply, Ali Moselhi, there is 'a real fear' of the government to touch the subsidy issue as a result of past unrest (personal interview, Cairo 2012). Archival sources point in the same direction. References to the food riots are paramount in the correspondence between the Egyptian government and the IMF, which was declassified in the early 2000s. Therein, the Egyptian government repeatedly insisted throughout the 1990s that 'the pace of reform had to be geared to the likely public reaction.'

The Untold Story: Politically Connected Actors

Fear of consumer unrest is the predominant narrative to explain the persistence of subsidisation. Though important, this narrative is incomplete without giving due attention to another group of beneficiaries from energy subsidies which have become an important lobbying group against major reform. In both countries, the untold story of the political economy of subsidy reform revolves around two key actors: politically connected businessmen (PCBs) and, in the case of Egypt, the army.

To understand this point, it is important to briefly explain how private sector actors benefit from the system in place. Regarding energy subsidies, it is first and foremost the energy-intensive sectors that reap an important part of the energy subsidies. These include, on the one hand, energy-intensive manufacturing sectors, such as cement, textiles, and chemical products. On the other hand, energy subsidies disproportionally benefit companies in the transport and logistics sector, which heavily rely on subsidised fuel.

To demonstrate how these actors have affected the system of energy subsidies, I rely on a novel dataset on PCBs and the Egyptian army that I compiled together with Adeel Malik at Oxford. Regarding PCBs, the dataset records the entry and presence of PCBs in Egypt and Tunisia at the four-digit level of the International Standard Industrial Classification (ISIC, Rev. 3.1) since 1997. As for the Egyptian army, the dataset only records the presence and not the entry of the army in ISIC 4-digit sectors and is thus time-invariant (for a detailed note on the methodology, see Eibl, Malik CSAE Working Paper 2016-27). The dataset seeks to capture Ben Ali- and Mubarak-era 'cronies', yet most of the identified actors can still be considered politically influential post 2011. The only exception are companies belonging to the Ben Ali-Trabelsi clan as these were subject to confiscations.

Based on this dataset, my argument relies on three important pillars:

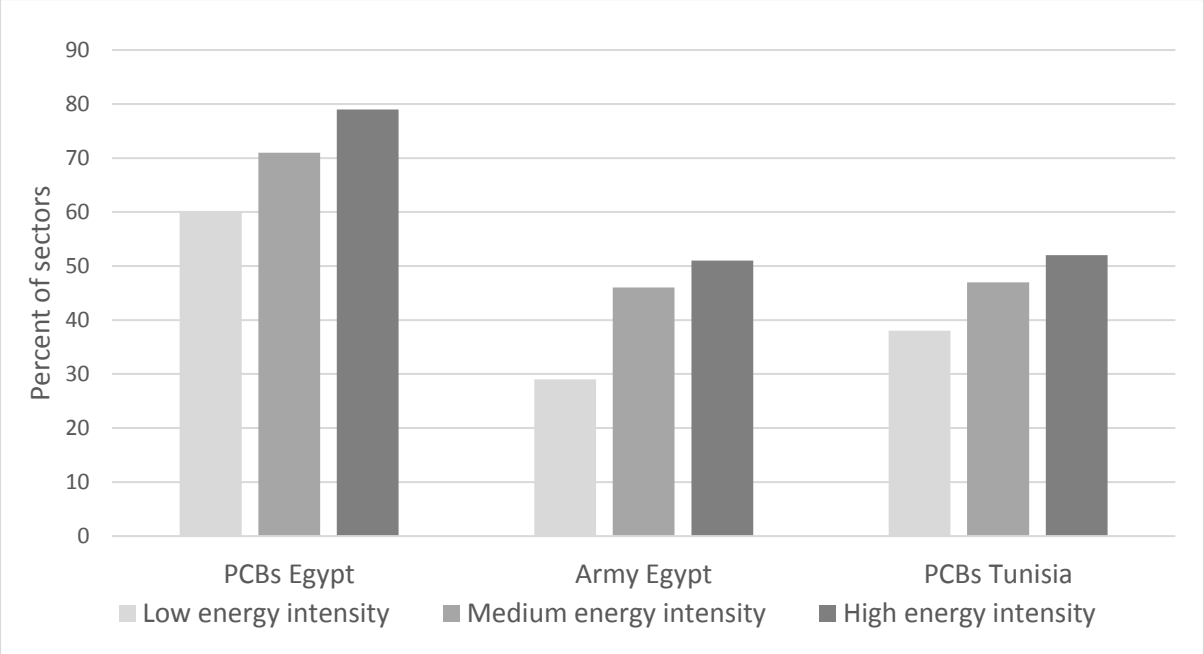
1. Presence in heavily subsidised sectors

Figure 1 below summarises the presence of politically connected actors in Egyptian and Tunisian manufacturing sectors in 2010. Failing a direct measure of energy subsidies to each sector, energy intensity is arguably the best proxy to capture the extent to which businesses benefit from energy

subsidies. Clearly, as Figure 1 below shows, political connected actors in Egypt and Tunisia display a significantly higher presence in sectors that benefit from energy subsidies. While Egyptian PCBs are 'only' present in 60% of low energy intensity sectors, their presence in sectors with high energy intensity amounts to nearly 80%. The picture for the Egyptian army and Tunisian PCBs is similar, albeit at lower levels: their presence is, respectively, 22 and 14% higher when comparing low to high energy intensity sectors.

While these descriptive figures are no evidence that these actors enter sectors *because of energy subsidies*, they nonetheless highlight the fact that politically connected actors have been amongst *the major beneficiaries of energy subsidies*.

Figure 1: Sectoral presence of PCBs and army by energy intensity



Note: Manufacturing sectors only. Classification of energy intensity taken from UNCTAD.

2. Entry into sectors because of energy subsidies

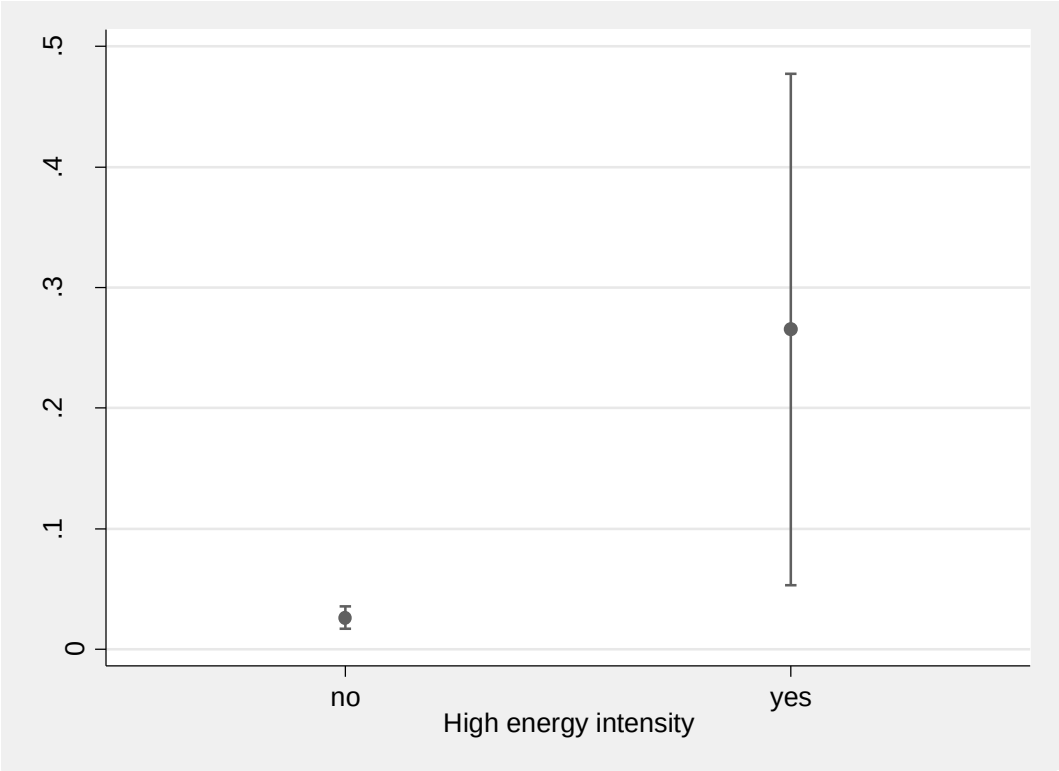
There is also evidence to suggest that politically connected actors enter sectors *because of energy subsidies*. Establishing this point is important as the entry into a sector because of energy subsidies gives us a much stronger indication of the importance of energy subsidies for these actors and, by extension, their (un)willingness to give them up in the future. For example, if it turned out that PCBs in Egypt enter sectors for reasons other than energy subsidies – such as skill intensity, level of imports and exports, etc. – this would suggest that they would not be a major obstacle to subsidy reform. If, on the other hand, energy subsidies are a primary factor driving entry into a sector, we would expect considerable resistance to systemic change given that their business model is, at least partly, predicated on the presence of cheap energy supplies. We would thus expect noticeable lobbying activity against subsidy removal.

To test this claim, I run a number of pooled and conditional fixed effects logit models which both suggest that the energy intensity – as a proxy for subsidies – is a key determinant of entry into a sector. This finding is particularly pronounced for PCBs in Egypt. The model takes the entry of 'cronies' as the dependent variable and a binary indicator of high or low energy intensity as the main explanatory

variable. It further controls for other confounders, such as level of tariffs, exports, imports, broad sectoral fixed effects, and skill intensity.

The most striking result can be found in the case of PCBs in Egypt, displayed in Figure 2 below. It shows that the average probability of an Egyptian PCB entering a sector is about 3% for low and medium energy intensity sectors, which increases to about 27% for high energy intensity sectors. With the average probability of PCB entry being 4% in the sample, this represents a significant increase and demonstrates the importance of energy subsidies in the entry decisions of politically connected entrepreneurs in Egypt. As for the Egyptian army, the results (not displayed) suggest that the army is about three times less likely to be present in low energy intensity sectors than in medium or high energy intensity sectors (21 vs. 65%). Only in Tunisia I could not find a systematic association between energy intensity and PCB entry. Taken together, this suggests that resistance from politically connected actors against subsidy reform should be expected to be higher in Egypt than in Tunisia.

Figure 2: PCB entry and energy subsidies in Egypt



Note: Predictions based on observed values from pooled logit model. Whiskers show 95-percent confidence interval.

3. Observed lobbying of politically connected actors against subsidy reform

There's anecdotal evidence that politically connected actors have used their leverage to lobby against subsidy reductions. For example, in July 2016 the head of the Federation of Egyptian Industries, Mohamed El Sewedy, declared that cutting natural gas prices for manufacturers is 'better for the state's budget' and would 'help reduce the budget deficit' as the benefits would outweigh the direct financial costs for the state. His lobbying efforts were met with partial success as the government

reduced gas prices from USD 7 per mmBtu to USD 4.5 per mmBtu for steel producers – despite the looming IMF agreement at the time and the stated goal of reducing energy subsidies. While this anecdote cannot be more than an illustration, it is nonetheless indicative of the important veto powers politically connected actors wield in the context of subsidy reform.